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Supreme Court of Canada hears GlaxoSmithKline case: focuses on business reality concept

On January 13, 2012, the Supreme Court of Canada (SCC) heard *GlaxoSmithKline*, the first transfer pricing case ever to be heard by Canada's highest court. The case is an appeal by the Crown of the July 10, 2010 decision of the Federal Court of Appeal (FCA), which overturned the earlier decision of the Tax Court of Canada (TCC). The Crown argued that the SCC should set aside the FCA decision and restore the decision of the TCC.[1] As part of a cross-appeal by GlaxoSmithKline (GSK), the parties also presented arguments on whether the FCA erred in sending the case back to the TCC.

The Crown's case

The Crown reiterated that GSK should have paid the same price as generic drug manufacturers for the active pharmaceutical ingredient, ranitidine. It argued that the FCA did not correctly interpret subsection 69(2) of the Income Tax Act (the Act) when it ruled that the wording "reasonable in the circumstances" requires consideration of GSK's "business reality". Pointing to the Organisation for Economic Co-operation and Development's transfer pricing guidelines, which state that arm's length analyses should be transactional, the Crown argued that the correct approach is to determine the price GSK would have paid on the open market for the active ingredient. It added that only economically relevant characteristics of the intercompany transaction under review should be considered, and that "business reality", including non-arm's length conditions such as GSK's obligation to buy the active ingredient at a "dictated price" under a licensing agreement, was not a relevant factor.

The SCC asked the Crown questions on its interpretation of the issue and, in particular, why it believes "reasonable in the circumstances" could not be broad enough to include "business reality". The SCC seemed to question whether subsection 69(2) of the Act was intended to be interpreted so strictly, and suggested the right question to ask was whether arm's length parties, in the same situation as GSK and wanting to sell Zantac, would have paid the same price for the ingredient.

[1] For background on the FCA decision, please see ***GlaxoSmithKline prevails at Federal Court of Appeal; but saga continues*** and ***The CRA appeals* GlaxoSmithKline *decision: arm's length standard versus business reality***

On the comparability issue, the SCC asked the Crown how it could consider generic product transactions to be comparable, given that the business model and reality of generic product manufacturers is different from that of GSK. The Crown replied that there was only one product to analyze (i.e., the ranitidine itself and not the manufactured drug).

GSK's case

GSK argued that the FCA did not err in its interpretation of subsection 69(2) of the Act in considering GSK's business reality, and that the correct question to ask was whether arm's length parties would have agreed to pay the same price GSK paid in order to be allowed to sell Zantac at a premium price. GSK added that it was not aware of any tax authority in the world ever arguing that the arm's length standard requires eliminating all consideration of relevant background or context to the transaction, as the Crown had argued.

The SCC raised the point that GSK had not fully demonstrated that arm's length parties would have entered into such an arrangement. In addition, the SCC expressed some discomfort with GSK bundling intellectual property (IP) rights with the ranitidine purchase price, suggesting that it looked like a "scheme" to avoid paying withholding tax. GSK replied that IP is always included in some way in a good's purchase price. It provided the example of importing a Porsche automobile, which is more expensive than other brands because it includes a premium for the name.

In respect of its cross-appeal, GSK asserted that the FCA erred by sending the case back to the TCC because it offends the limitation periods in the Act. GSK argued that by doing so, the Minister would be afforded the opportunity to change positions and bring new arguments, even though the statutory limitation period has passed.

Next steps

We can expect a decision from the SCC within the next 12 months. However, it will not necessarily mean the end of the GSK case, as the SCC could ultimately agree with the FCA decision to send the case back to the TCC. If so, the TCC would have to render a decision based on the guidance set by the SCC.

This decision by the SCC should provide greater certainty as to the application of the arm's length principle in Canada. However, since the GSK case involves the Act's now repealed subsection 69(2), which has different wording from the current subsection 247(2), it remains to be seen whether the SCC's new guidance will be applicable in the context of subsection 247(2).

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